



# The Investment Adviser “Switch”

A Report on the 2012 Transition of Mid-Sized Investment Advisers  
from Federal Registration to Missouri State Regulation

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**Missouri Securities Division  
Office of Secretary of State Robin Carnahan**

Informed investors are better able to reach their investment goals and protect their life savings. Through their financial expertise and fiduciary services, investment advisers play an important role helping investors remain informed and reach their financial goals. Thus, to aid investors in attaining their financial goals, the Secretary of State and the Commissioner of Securities ensures that investment advisers have a monitored and robust market in which to respond to Missourians' needs.

Moreover, part of being an informed investor includes some awareness of the laws that regulate securities professionals, including investment advisers. This awareness should include, not only changes in the laws that affect investors, but also who is regulating investment advisers and how that regulator is promoting investor protection.

To that end, the Missouri Securities Division (the "Division") is issuing this Investment Adviser Switch Report. This report summarizes recent legislation that altered the legal landscape for investment advisers, investors, and securities regulators across the country. The report also informs you how the Secretary of State, the Commissioner of Securities, and the Division are responding to those changes and ensuring that Missouri investors continue to benefit from this state's well-regulated and strong investment adviser community.

#### *The Dodd-Frank Act*

In response to the fraud perpetrated by Bernard Madoff and other perceived failings of the financial services industry, Congress in 2010 enacted the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank Act"). Codified in the Dodd-Frank Act were significant changes to how investment advisers are regulated. Generally speaking, an investment adviser must register with either the U.S. Securities and Exchange Commission ("SEC") or the investment adviser's state securities regulator. Under Federal law, with whom an investment adviser must register is determined by the dollar value of the total assets that the adviser is managing for its clients (this amount is called the "assets under management," or AUM). Prior to implementation of the Dodd-Frank Act's investment adviser provisions, an investment adviser with a relatively low AUM (under \$25 million) was regulated by the state regulator, leaving the larger investment advisers to the SEC. But, if a smaller, state-registered investment adviser's AUM increased past a certain dollar threshold, then the adviser would have to register with the SEC.

The Dodd-Frank Act raised the AUM threshold to be SEC registered, effectively increasing the population of investment advisers registered with the state securities regulators. Thus, the Dodd-Frank Act required that investment advisers with an AUM between \$25 million and \$100 million ("mid-sized investment advisers")—who had previously been registered with SEC—must switch their registration to their state regulator. This federally-required transition to state regulation has been termed the "IA Switch."

The Dodd-Frank Act also directed the SEC to establish rules facilitating the IA Switch, including setting key dates and deadlines. To that end, the SEC promulgated rules in 2011 creating deadlines for the switch of mid-sized investment advisers to state registration. Those rules established:

- **March 30, 2012**, as the last day for investment advisers to update their AUM on FORM ADV<sup>1</sup> (in effect indicating whether they were required to switch to state registration), and

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<sup>1</sup> Form ADV is the disclosure document each investment adviser must file (and keep updated) with the states and the SEC to become and remain registered. It contains detailed information about each firm's advisory business.

- **June 28, 2012**, as the deadline for mid-sized investment advisers switching to state registration to withdraw their registration from the SEC (a necessary first step to registering with the states).

The promulgation of those and other rules by the SEC set in motion one of the largest coordinated shifts in the history of securities regulation, as state regulators, primarily working through the North American Securities Administrators Association (“NASAA”), and the SEC worked together toward a seamless and synchronized transition. Among state regulators, Missouri took a lead role in engaging the investment adviser community.

#### *Outreach*

In the months that followed the adoption of the Dodd-Frank Act, the Division reached out to Missouri’s investment advisers, successfully informing that community about issues related to the IA Switch. The following is a timeline of some of the Division’s proactive steps that facilitated the IA Switch for this state’s investment adviser community:

- **September 16, 2010:** The Division implemented a Pre-Registration Examination program. Through that program, Division auditors evaluated the application materials and business practices of investment advisers applying for Missouri registration to ensure compliance before applicants were approved for registration. This program would serve as a key component of the Division’s effort to properly vet incoming mid-sized investment advisers while also preemptively preventing delays from the surge of switching investment advisers.
- **April 1, 2011:** The Division hosted a “listening session” with the industry in Kansas City, Missouri, to discuss the Division’s responses to the latest Dodd-Frank developments.
- **April 13, 2011:** Commissioner of Securities Matt Kitzi issued an advisory release ([AR-11-02](#)) on the potential delays in investment adviser transition to state registration.
- **April 17, 2011:** The Division hosted a “listening session” with the industry in St. Louis, Missouri, to discuss the latest Dodd-Frank developments, and the Division’s proactive responses to those developments.
- **April 26, 2011:** The Division launched a [website](#) devoted entirely to the IA Switch. The Division’s IA Switch website included answers to frequently asked questions, advisory releases issued by the Commissioner, links to articles regarding the IA Switch, and guidance on applying for Missouri registration and other switch-related issues.
- **April 27, 2011:** The Division’s “IA Switch Team” sent the first of a series of email alerts to a listserv of attorneys, compliance personnel, industry members, and other interested persons.
- **June 24, 2011:** The Division’s Chief Counsel, Patrick T. Morgan, hosted a continuing legal education event in Kansas City, Missouri, regarding the Dodd-Frank Act.
- **July 7, 2011:** Commissioner Kitzi issued an advisory release ([AR-11-03](#)) on key IA Switch dates and the SEC’s promulgation of IA Switch rules.
- **July 20, 2011:** Commissioner Kitzi issued a no-action determination and related advisory release ([AR-11-04](#)) regarding the impact of the Dodd-Frank Act on a Missouri investment adviser to private funds (and related registration exemptions).

- **December 15, 2011:** Commissioner Kitzi issued an advisory release ([AR-11-07](#)) regarding the Division's participation in NASAA's Coordinated Review Program.<sup>2</sup>
- **December 29, 2011:** The Division sent a [letter](#) to mid-sized investment advisers expected to switch to Missouri registration outlining the procedure and timeline for switching their registration.
- **February 24, 2012:** The Division published the first issue of its quarterly newsletter, which included guidance on the IA Switch.
- **March 23, 2012:** Commissioner Kitzi issued an advisory release ([AR-12-01](#)) on the deadlines and best practices for advisers switching to state registration.
- **April 26, 2012:** Commissioner Kitzi filed a [proposed rule](#) amending the Private Fund Adviser exemption, which exempts some advisers from the need to register in this state.
- **April 26, 2012:** Commissioner Kitzi issued an advisory release ([AR-12-03](#)) on a proposed amendment to Missouri's Private Fund Adviser exemption.
- **May 17, 2012:** Commissioner Kitzi issued a no-action determination and related advisory release ([AR-12-04](#)) contemplating the rulemaking concerning Missouri's private fund advisers.
- **June 15, 2012:** The Division sent a letter to expected switching advisers that had not yet applied for Missouri registration, urging them to submit their registration application to the Division immediately.
- **July 3, 2012:** Commissioner Kitzi issued a no-action determination and related advisory release ([AR-12-05](#)) concerning investment adviser registration applications filed prior to but still pending after the deadline to withdraw from SEC registration.

In addition to the above enumerated efforts, Division attorneys, auditors and licensing staff answered hundreds of switch-related phone and email inquiries during the course of the IA Switch. Importantly, as mid-sized investment advisers initiated the process to switch to state registration, Division auditors walked each applicant, step-by-step, through their transition.

#### *Switch Registration*

According to the SEC's initial estimates, the Division entered 2012 anticipating that approximately 120 mid-sized investment advisers (50 of which were Missouri-based) would switch from federal registration to Missouri registration. After the AUM update filing deadline passed on March 30, 2012, those estimates were revised, and the Division was given a list of 38<sup>3</sup> Missouri-based mid-sized investment adviser expected, based on AUM filings, to switch to state registration.<sup>4</sup>

In the first two quarters of 2012, Division auditors Jennifer Henley, Nick Burton, Amita Mehra, Ashton Cope and Dori Craighead (together, the "Audit Unit") completed Pre-Registration Examinations of 62 investment

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<sup>2</sup> NASAA's Coordinated Review Program was designed for use by mid-sized investment advisers required to switch to state registration in 4-14 states. Investment advisers that elected to participate in the Coordinated Review Program had their application materials evaluated concurrently by the states, rather than working through the application process with each jurisdiction separately.

<sup>3</sup> The SEC attributed the significant drop in the initial estimate of expected switching firms to those firms either increasing their AUM, merging with other firms, or going out of business entirely.

<sup>4</sup> The revised estimates did not include a list of out-of-state investment advisers expected to switch to state registration in Missouri.

advisers switching from federal to state registration. Those 62 completed Pre-Registration Examinations amounted to a 23% increase in production over all of 2011.<sup>5</sup>

Of those 62 Pre-Registration Exams:

- 31<sup>6</sup> were of investment advisers based in Missouri;
- 4 were completed in tandem with other states as part of NASAA's Coordinated Review Program;
- 2 resulted in referrals to the Enforcement Section; and
- 2 eventually terminated their registration.

During the course of those examinations, the Audit Unit evaluated a switching adviser's application materials and business practices. When that adviser's application materials contained deficiencies, the Audit Unit worked with the adviser to cure those deficiencies.

Common Pre-Registration Examination deficiencies of switching investment advisers included:

1. Client contracts that contained inappropriate or misleading arbitration clauses and hedge clauses.
2. Failure to include a 48-hour/5-day termination provision in the client contract.
3. Inconsistencies between the adviser's Form ADV information and its client contracts.
4. Inaccurate and/or incomplete disclosure of the adviser's other business activities.
5. Failure to maintain updated client information, which is necessary to enable the investment adviser to determine whether its investment advice is suitable for a client.

As a whole, the deficiencies found during the Pre-Registration Examinations of mid-sized investment advisers substantially mirrored the common deficiencies found during similar examinations of other, smaller investment advisers. By examining mid-sized investment advisers before registration, the Audit Unit was able to ease the advisers' transition to state regulation by proactively reviewing their compliance with the Missouri Securities Act of 2003 and suggesting best practices for the future.

Beyond promoting each switching adviser's compliance with the state's securities laws, the Pre-Registration Examination Program enabled the Division to collect valuable information about Missouri's newest mid-sized investment advisers.

#### *Missouri's New Mid-Sized Investment Advisers*

Prior to the switch of mid-sized investment advisers to state registration, the 316 investment advisers already registered in Missouri ("small investment advisers") managed approximately \$3.9 billion in assets. With the addition of mid-sized investment advisers to Missouri's population of registered advisers, the total value of assets managed by the state's registered investment advisers—now numbering 376—jumped to almost \$7 billion, representing a 78% increase.

In addition to advising, on average, a larger amount of assets per adviser, Missouri's mid-sized investment advisers may also have different business models and/or practices. Although many of those differences will

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<sup>5</sup> In 2011, the Audit Unit completed 51 total Pre-Registration Examinations.

<sup>6</sup> Of the 38 Missouri mid-sized investment advisers expected to switch, seven did not apply for state registration. That is likely attributable to the same issues listed above in footnote 3.

likely be discovered during routine field examinations already scheduled to be conducted by the Division's Audit Unit, Form ADV filings provide some insight regarding potential differences.

Listed below is a comparison of mid-sized investment advisers and small investment advisers by certain key characteristics:

Characteristic	Mid-Sized Advisers	Small Advisers
Number of firms	<b>60</b>	316
Average AUM	<b>\$50.7m</b>	\$12.4m
Total employees	<b>330</b>	1,568
Average number of employees	<b>5.5</b>	5
Also registered as broker-dealer	<b>5%</b>	8%
Offer financial planning services	<b>58%</b>	66%
Have custody of client securities or cash	<b>6%</b>	4%
Directly deduct fees from client accounts	<b>92%</b>	68%
Have more than 100 clients	<b>30%</b>	11%
Advise pooled investment vehicles	<b>2%</b>	2%
Charge fees as a percentage of AUM	<b>98%</b>	81%
Charge hourly fees	<b>57%</b>	61%
Charge performance-based fees	<b>3%</b>	8%
Have employees that are registered as investment adviser representatives with another investment adviser	<b>15%</b>	12%
Have employees that are registered as agents with a broker-dealer	<b>37%</b>	27%
Have employees that are licensed as insurance agents	<b>52%</b>	42%
Conducts seminars/workshops	<b>8%</b>	5%
Has been found by a federal or state regulatory agency to have violated investment-related regulations or statutes	<b>10%</b>	6%
Has entered into a consent order with a federal or state regulatory agency in connection with investment related activity within the last 10 years	<b>8%</b>	5%
Buys or sells securities recommended to clients	<b>87%</b>	70%
Receives soft dollar benefits from either a broker-dealer or third party in connection with client securities transactions	<b>37%</b>	27%

Beyond the apparent differences attributable to size (AUM, average employees, number of clients, etc.), certain risk-related characteristics are more prevalent in mid-size investment advisers. Each of those characteristics creates potential conflicts of interest requiring disclosure to clients, and merits greater scrutiny by Division auditors during an examination.

Succinctly, mid-sized investment advisers, in comparison to small investment advisers, more frequently:

- Employ professionals with multiple licenses (for instance, professionals authorized to act as a broker-dealer agent, an insurance agent, or an investment adviser representative);

- Receive soft-dollar benefits<sup>7</sup> from broker-dealers or third parties related to client transactions;
- Buy or sell securities they also recommend to their clients;
- Directly deduct their fees from client accounts; and
- Have been the subject of a regulatory enforcement action.

The Audit Unit will use this and other ADV information to prepare for its future field examinations of mid-sized investment advisers. However, because the information in ADV filings is sometimes inaccurate or inconsistent, the Division will still face unique challenges as mid-sized investment advisers are incorporated into the Audit Unit's examination cycle.

#### *The Division's Plans for the Coming Year*

In the next ten months, the Division plans to conduct a routine field examination of each of Missouri's newly-switched mid-sized investment advisers. Because the SEC oversaw so many investment advisers before the Dodd-Frank Act's changes, many mid-sized investment advisers may have never previously been audited. As a result, experiencing a regulatory examination may be relatively new for some of Missouri's mid-sized investment advisers. To introduce them to the state regulatory structure, the Division will provide each audited adviser an informational packet beforehand, describing the Division's functions and reiterating the adviser's statutory and regulatory responsibilities.

The Division will prioritize its audits based on ADV filings and information collected during the Pre-Registration Examination process.

Factors that will be considered when prioritizing audits include, among others:

- Regulatory/disciplinary history of the investment adviser firm and its representatives;
- Whether the firm has custody of client funds or securities, a situation that requires close observation by the client, the adviser, and securities regulators;
- Whether the firm directly deducts fees from client accounts;
- The type of products the firm advises its clients to purchase, such as complex securities or little-known investment devices;
- Whether the firm or its representatives are dually registered, that is, legally authorized to act as both an adviser and a broker-dealer (or its agent);
- The outside business activities of the firm's representatives;
- The date (and results) of the firm's last regulatory examination; and
- Whether the firm acts as adviser to one or more private funds.

After finishing the examination of the priority mid-sized advisers, the Audit Unit will select audit targets at random until each mid-sized investment adviser has been audited.

Each of those examinations will be led by the auditor that completed the subject adviser's Pre-Registration Exam, and similar to that exam, the auditors will identify deficiencies, ensure the advisers cure those

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<sup>7</sup> Soft-dollar benefits are a form of compensation (including research, products or services) that investment advisers receive from broker-dealers or other third parties in connection with client securities transactions.

deficiencies, and pass along suggested best practices. In some cases, if the auditors identify violations of the Missouri Securities Act of 2003, they will refer the matter to the Enforcement Section for formal investigation.

In addition to evaluating each investment adviser's legal compliance, the Division will take note of the effectiveness of its current examination procedures and practices. As auditors encounter new challenges in the field, they will share those issues with Chief Registration Counsel Drew Veatch so the approach of future examinations can be adjusted to better meet those challenges.

After the initial mid-sized investment adviser examinations have been completed and the findings have been analyzed, each mid-sized investment adviser will be placed on a future audit cycle based on the perceived level of risk within the firm. The findings from the initial round of mid-sized investment advisers will also be consolidated and incorporated into training materials to prepare the Audit Unit for future examinations.

Finally, one year from now, the Division will again evaluate its progress and analyze the impact of the IA Switch, not only on the policies and procedures of the Audit Unit, but also the Division as a whole.